Reply Report of Keith Leffler in Costco Wholesale Corp. v. Hoen, et al

1. I have been asked by counsel for Costco to respond to some of the arguments, assertions and misunderstandings evident in the expert report filed by John Casavant.

2. Professor Casavant confuses regulations that impose "concerted behavior" and thereby directly constrain private price setting, with those regulations that promote and facilitate concerted behavior in a system of apparent private pricing decisions. In this later case, the regulations lead to above competitive prices. As discussed in my initial report, the WSLCB regulations directly impede competition among the wholesalers of beer and wine. The regulations do this in a variety of ways, including the reductions of non-price discounts through credit and delivery terms, by increasing pricing transparency through mandatory advance price posting, and by stabilizing prices through "post and hold" requirements. In addition, the WSLCB regulations directly interfere in wholesale competition by preventing retailers from performing certain functions such as setting up direct shipments from a manufacturer, centralizing retail inventories, and selling for resale. The results of these regulations are the same (or more effective) than if set by horizontal agreement. And these regulations are the type of limits on competition that firms seeking to engage in concerted action would impose as the regulations facilitate concerted behavior.

3. Professor Casavant apparently believes the WSLCB regulations cannot facilitate concerted behavior because "decisions as to the initial price of any particular items are made by the individual producers" (p. 8). Professor Casavant's claims in this regard are contrary to basic economic principles and methods, because the regulations can impact the competition among the distributors regardless of the level of competition in the manufacturing sector. In addition, his belief that the initial price is competitive is not factually correct because the WSLCB regulations include minimum markups by the manufacturers

4. Professor Casavant asserts that the purpose of the WSLCB regulations includes a desire to increase the price of beer and wine in order to control abusive consumption of alcohol. However, he concedes that the regulations in fact are contrary to any such purpose since the result of the regulations is the "cross-subsidization" of certain types of retailers such as "mom and pop" and outlying area retailers (p. 10).[1] That is, Professor Casavant concedes that as a result of the WSLCB regulations, some retailers pay <u>less</u> for beer and wine than otherwise would be the case. Professor Casavant provides no analysis as to how lower prices for some retailers and higher prices for others might reduce abusive consumption of alcohol. In particular, he fails to consider in any way whether the retailers that pay lower prices because of the regulations are those retailers that are least likely to have standardized and institutionalized identification and sales

[1] All citations are to page numbers in the Casavant Report.

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control procedures, and therefore, might be the less likely sources of alcohol for alcohol abusers such as minors or drinking drivers.

5. Professor Casavant also concludes that one of the purposes of the WSLCB regulations is to raise revenue for the state. If that is in fact one purpose along with reducing consumption, the set of actual regulations are a most bizarre method of accomplishing those purposes. Rather than introducing economic distortions and inefficiencies into the system via a complex host of rules and regulations, the state could simply increase the tax on alcoholic products, thereby maximizing state revenue and maximizing any demand reducing effect of higher prices.

6. Professor Casavant also concludes that one of the purposes of the regulations is to promote "fairness." He never defines what he (or the state) means by fairness. I assume he must have in mind some concept of economic fairness in which competitors are allowed to compete in the manner most appropriate for their particular expertise, skills and business organizations. A uniform pricing system does not allow this.[2] In addition, the regulatory system imposed by the WSLCB is one of cross-subsidization, one in which efficiency in distribution and retailing is impeded, and one in which competition is thwarted. Such a system of regulation hardly seems consistent with any notion of economic fairness.

7. Professor Casavant writes that "[f]airness and a level playing field" … "are goals of the uniform delivered price [regulations]." (p. 9) He does not base this claim on any economic analysis, economic theory or evidence. Contrary to Professor Casavant's assertions about fairness, the WSLCB regulations that prevent some retailers from utilizing the competitive characteristics and advantages of their particular business organization can certainly not be considered as "leveling the playing field." Retailers like Costco and Safeway offer low markups to their customers at the expense of convenience and service. The WSLCB regulations constrain these retailers from taking advantage of their favored competitive tools. Yet the regulations impose no such constraints on the "cross-subsidized" retailers' favored methods of competing. Convenience stores are still allowed to sell from locations near consumers, to have parking right near the store, and to have short aisles and lines. The WSLCB regulations have "tilted" rather than leveled the playing field in favor of the cross-subsidized retailers. The logic of Professor Casavant's assertions in this regard is analogous to Major League Baseball "leveling the playing field" by not allowing left handers to bat or throw from the left.

[2] This is illustrated by the Robinson-Patman Act which was designed in part to foster "fairness" by constraining price discrimination. The Robinson-Patman Act allows prices to fully reflect cost differences such that, for example, quantity discounts are allowed when justified by cost savings of serving larger purchasers, and distributors can offer different service levels to different buyers. In addition, I note that the WSLCB regulations regarding uniform prices impose uniformity only with respect to an individual distributor's prices. Therefore, consumers may certainly have choices between retailers that pay different prices because they are served by different distributors.

8. Professor Casavant claims that the WSLCB's price posting requirement "is an enforcement mechanism that makes the other provisions of the law more enforceable and more effective," (p. 7) and that "[t]hey are an effective way to enforce the 10% minimum markup requirement and uniform pricing" (p. 9). However, to the extent that price posting is used to more effectively enforce other anticompetitive aspects of the WSLCB regulations, the posting is itself anticompetitive. In addition, Professor Casavant provides no discussion as to how or whether price posting accomplishes any enforcement purpose. He does not describe any ways in which the WSLCB monitors the actual wholesale transactions' prices as compared to the posted prices, and the evidence indicates that WSLCB does no such monitoring.[3] Professor Casavant's opinions in this regard are unsubstantiated as he provides no economic theory, analysis, evidence or data of how posting prices assist in enforcing no credit, no delivery to retailers' warehouses, or no quantity discounts rules. He rather asserts with no explanation or support that the "the 'hold' on prices is the principal vehicle for enforcement of uniform pricing, the ban on quantity discounts, the ban on credit sales, and other 'tied-house' provisions." Such assertions are not substitutes for economic analysis.

9. Professor Casavant also asserts that "[t]he 'hold' [in posted prices] ... facilitates orderly marketing, avoiding the drastic swings in product prices that bring about over- and under-orders, returns, consumer uncertainty, etc." (p. 9) Professor Casavant provides no analysis, data or other evidence demonstrating that such "drastic swings in product prices" either occur or are a problem for the many, many products sold by retailers that are not the subject of the restrictions on distribution efficiency imposed by the WSLCB regulations. A basic economic proposition underlying the antitrust laws is that a competitive market solves "orderly marketing" far more effectively than does a regulated system. Absent some demonstration or evidence that this is not true in a particular situation, Professor Casavant's abstract, unlikely possibility provides no economic support, justification, or substantiation for the WSLCB regulatory system. A related purported economic benefit from the WSLCB posting and markup regulations, according to Professor Casavant, is that "we do not witness drastic price decreases as firms attempt to clear the market by selling off surpluses." Professor Casavant again provides absolutely no analysis, data, facts or evidence demonstrating that such drastic price decreases are economic reality absent constraints such as the WSLCB regulations.

10. Professor Casavant asserts that "[t]he minimum markup ... insur[es] that low prices, due to volume or market power, would not be over-used ...." (p. 8).[4] Professor Casavant does not define what he means by "low-prices" being "over-used." Competition and efficiency in distribution is socially desirable whether the

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[3] Deposition of Heidi Ensign, pp. 16-19, 61.

[4] This concern seems at odds with Professor Casavant assertion that the costs of distribution are substantially in excess of 10% (p. 6). However, as explained in my initial report, special deals at prices less than 10% above distributor costs are commonly available in other states.

state seeks higher or lower prices of alcoholic products. High or low prices versus competition and efficiency are simply distinct and separate issues. The state can effectively and simply cause alcoholic products to have prices as high as the state desires by imposing taxes.

11. According to Professor Casavant "[a]llowing quantity discounts and granting of credit would have the effect of lowering prices to those consumers who can shop at big box stores." (p. 10) This assertion about the impact on consumer prices at "big-box" stores from removing the quantity discount and credit constraints is supported by no analysis, data or evidence. However, in my initial report, I did discuss how allowing efficient retailers to take advantage of cost justified quantity discounts and credit would likely lower the overall cost of distribution. With a competitive retailing sector, it is likely that retail prices for the sellers would fall some as a result. Professor Casavant goes on to assert that the consequence of such lower retail prices would be "increases in quantity consumed and an increased opportunity for abuse." This conclusion does not follow because, according to Professor Casavant some retailers are subsidized and the prices at these less efficient, cross-subsidized retailers would increase. The net impact, therefore, cannot be known. In addition, Professor Casavant fails to consider the likely magnitude of any likely very small such change.

12. Professor Casavant goes on to assert that "[e]liminating the ban on quantity discounts and credit sales would also raise the specter of reemergence of 'tied-house' saloons and related problems" (p. 10). What the "related problems" are, he doesn't tell us. Nor does he explain how any such problems are related to quantity discounts and credit sales. He rather assumes the answer "explaining" that there "would be increased pressure on market participants to increase volume movements and an attendant increase in abusive consumption." These assertions certainly do not derive from any economic principles. I am aware of no logical or economic relationship in the current marketplace between quantity discounts and credit sales and "tied houses" and Professor Casavant provides none, nor does he provide any analysis, evidence or data demonstrating that there is any such link. Professor Casavant also fails to recognize federal constraints on "tied-houses" that are independent of the WSLCB regulations.[5]

13. The over-riding theme of Professor Casavant's report is that the state has a legitimate role in controlling abusive alcohol consumption and that the hodge podge of WSLCB regulations accomplish that goal by reducing overall consumption through higher prices.[6] However, in an apparent contradiction to this assertion, Professor Casavant suggests that one benefit from the cross-

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[5] 27 USC §205(b) (6), 27CFR§6.65.

[6] Professor Casavant argues that the WSLCB regulations are somehow related to the economic externalities ("social costs") from alcohol consumption (p. 12-14). However, he does not demonstrate any relationship between the WSLCB regulations and the actual social costs. In addition, the regulations impact all prices and not simply those to purchasers that cause any social costs. Therefore, I conclude that there is no actual relationship between the regulations and the control of social costs.

subsidization is in making beer and wine more available in outlying areas (p. 10) (and presumably thereby increasing consumption and the opportunities for abuse in those areas.) As is generally true in his report, Professor Casavant offers no supporting economic theory, logic, evidence or data analysis supporting his conclusion. Nonetheless, as explained in my initial report, I would expect that high distribution cost retailers would pay higher prices absent the cross-subsidization implicit in the current regulations. This expectation is, however, far removed from any claim that "some people would have their access to alcohol dramatically curtailed." To pile assertion on assertion, Professor Casavant then claims that the removal of the cross-subsidization will result in "the strong incentive for illicit manufacturing"!

14. According to Professor Casavant, elimination of minimum markups would result in "some [loss of] control at the distributorship level as they [distributors] fight against large breweries" (p. 11). I am not sure what Professor Casavant means. Current antitrust laws governing competition appear to be more than sufficient to protect access to retailers regardless of whether there are or are not large manufacturers. In addition, given the importance of microbrews to retailers it seems far fetched to believe that any retailer would find it in its self-interest to carry only the brands of large breweries.[7]

15. Professor Casavant provides a discussion of the "Performance of the Three-Tiered System" (p. 15-17). He, however, offers no testable hypotheses as to any benefits from such a system, but rather a series of unsupported assertions. For example, he claims that "separation of producers from retailers ... was a principal source of many of the undesired results leading to prohibition" (p. 16). He doesn't explain in any way what these undesired results were and how having production separated from retailing has any impact of these unknown undesirable results. Professor Casavant also states that "[v]ertically integrated industries, operating without independent distributors, lead to brand-building efforts such as excessive advertising and provision of additional services" (p. 16). He, however, provides no substantiation through theory, data or evidence in support of this claim. I have been studying and teaching about vertical integration for thirty some years. There is, in fact, no theoretical or empirical support for the Casavant statement.

16. Professor Casavant's discussion of the three-tiered system also demonstrates a fundamental flaw in his approach to understanding the economic impact of the WSLCB regulations. He notes how these regulations were adopted in response to the ending of prohibition. He then references various purported problems that led to prohibition such as "the 'saloon' and its social ills" (p. 5), "bootlegging" (p. 6), "stop[ping] breweries from controlling and forcing the actions of the retailers" (p. 7), "elimination of illegal alcohol sales and the attendant loss of taxes" (p. 5), and "the specter of the reemergence of the 'tied house' saloons." Regardless of whether Professor Casavant has correctly described the original motivations for

[7] Given the very large number of wine brands, there also is no basis for any concern about "large" wineries to limit retailers stocking of competing wines.

and intent of the WSLCB regulations, plaintiff in this case challenges the economic impact of these regulations in 2005. And in analyzing that economic impact, what is important is the nature of the market in 2005. First of all, Professor Casavant simply ignores substantial evidence that the WSLCB and the liquor control regulation have been "captured" by the beer and wine distributors.[8] Professor Casavant also ignores the tremendous economic changes that have occurred since the adoption of the WSLCB regulations. For example, modern information systems certainly impact the state's ability in controlling illegal sales and collecting taxes. Similarly, the development and growth of large, chain retailers makes any concerns about breweries controlling retailers a relic of the distant past. With his emphasis on the historical basis of the WSLCB regulations, Professor Casavant's approach simply provides no guide as to how the economic realities of the market today impact the relationship between the historical "problems" and the WSLCB regulations. I have seen no analysis or economic research by the WSLCB that support or justify the economic impact of the regulations, and, in my opinion, the unsubstantiated assertions by Professor Casavant do not provide that support or justification.

17. Professor Casavant concludes his report by listing some of the services distributors can provide to retailers. Distributors may rotate and stock shelves. They may take back out of date product. They may carry the risks of experimental varieties. And they may do none of these things. Depending on the particular product and the particular retailer, different decisions as to the efficient method of distributing products are made. Yet, after listing possible distributor services, Professor Casavant reaches the improper conclusion that because of the WSLCB regulations mandating use of distributors"[m]any more wine labels, and therefore smaller wineries, are carried, inventoried and made available to the consumer by the distributors." He explains this non-sequitur with the assertion that "[t]his is possible because the larger companies can afford to carry an expensive inventory." (I note the inconsistency with his earlier claim that it is vertical integration that leads to excessive services.) But, first of all, a particular product is carried in inventory, by a distributor large or small, or a retailer large or small, because the seller expects to make a profit selling the product. There is no economic reason to believe this incentive and the resulting variety of available product is affected in any way by WSLCB regulations. In addition, if "largeness" was of some importance to carrying an expensive inventory, it would be retailers such as Krogers, Safeway, Albertsons, Sam's Club, Costco, Rite Aid, and Walgreens who could best perform this function, not the relatively much smaller wine and beer distributors.

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[8] See, for example, RESPTOCOSTCORFP 5959-60, 102-104, 44493; WBW 001235-36, 001050, WSA 00513-518. The concept that regulatory agencies can be captured by the industry they regulate comes from "The Theory of Economic Regulation," (Bell Journal of Economics, 2, 1971:3-21) written by George Stigler, the Nobel Prize winning economist. Professor Stigler presented and provided evidence for the hypothesis he labeled the "capture theory." Under this theory, Stigler argued, governments limit competition in industries at the behest of producers who "capture" the regulatory agency.

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Keith Leffler

7/1/05

Date